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Federal Agencies Issue Final Regulations to Implement the Volcker Rule

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TO: ACCOUNTING/TREASURERS MEMBERS No. 31-13
BOARD OF GOVERNORS No. 16-13
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 35-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 88-13
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 39-13
ETF ADVISORY COMMITTEE No. 38-13
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OPERATIONS MEMBERS No. 20-13
SEC RULES MEMBERS No. 114-13
SMALL FUNDS MEMBERS No. 65-13
UNIT INVESTMENT TRUST MEMBERS No. 22-13 RE: FEDERAL AGENCIES ISSUE FINAL REGULATIONS TO IMPLEMENT THE VOLCKER RULE

On December 10, 2013, the Securities and Exchange Commission, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Commodity Futures Trading Commission (collectively, “Agencies”) adopted final regulations to implement Section 619 of the Dodd-Frank Act, the so-called “Volcker Rule” (“Final Regulations”). [1] The Volcker Rule and the Final Regulations seek to limit perceived risks associated with activities of banks and their affiliates and subsidiaries (referred to as “banking entities”) related to proprietary trading and investments in, and sponsorship of, hedge funds, private equity funds and other similar funds (referred to as “covered funds”). The Final Regulations contain important differences from the rules first proposed by the Agencies (“Proposed Rule”).

This memorandum provides a preliminary overview of the Final Regulations, focusing on areas of concern to U.S. registered investment companies and their non-U.S. counterparts (collectively, “registered funds”), as discussed in the February 2012 comment letters filed

by ICI and ICI Global on the Proposed Rule. Given the significant revisions to the Proposed Rule (discussed at length in a 900-page preamble to the Final Regulations), it is possible that other issues may arise, including new issues created by the revisions or by the interrelationships of the various provisions in the Final Regulations, or issues stemming from the guidance embedded in the preamble. We are continuing to analyze the implications of the Final Regulations and encourage members to bring any issues of concern to our attention.

Organization, Sponsorship and Normal Activities of Registered Funds

Treatment of U.S. Registered Funds under the Definition of "Covered Fund"

Section 619 of the Dodd-Frank Act prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or "similar fund" as the Agencies determine by rule—collectively defined as "covered funds." The Proposed Rule would have included within "covered fund" any investment vehicle that is considered a "commodity pool" under Section 1a(10) of the Commodity Exchange Act, including some registered funds. ICI recommended that the Agencies provide an express exclusion for registered funds from the definition of "covered fund" and noted that such an exclusion would be consistent with Congressional intent.

In the preamble, the Agencies indicated that they did not intend to include registered investment companies as covered funds under the proposal. They commented that Congress' focus on funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act appears to reflect its concern regarding funds that are explicitly excluded from SEC regulation as investment companies.

Accordingly, the Agencies stated that they do not believe that it would be appropriate to treat a registered investment company as a covered fund. The Final Regulations both narrow the universe of commodity pools that will be included as covered funds and provide an express exclusion for SEC-registered investment companies from the definition of covered fund. [2]

The Agencies noted that an entity that eventually becomes a registered investment company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. The Final Regulations exclude these seeding period companies from treatment as covered funds, subject to certain requirements.

Treatment of Non-U.S. Retail Funds under the Definition of "Covered Fund"

The Proposed Rule included within "covered fund" any issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act. This expansive definition included virtually all securities or futures-related investment funds outside the United States. Both the ICI and ICI Global comment letters recommended that the Agencies expressly exclude non-U.S. retail funds from the definition of covered fund. We asserted that non-U.S. retail funds are not managed or structured like hedge funds or private equity funds, and excluding them from the definition of "covered fund" would be consistent with Congressional intent to limit the extraterritorial impact of the Volcker Rule.

The Final Regulations seek to address concerns about the treatment of non-U.S. retail funds by excluding certain foreign public funds from the definition of covered fund (the "Foreign Public Fund Exception"). The Foreign Public Fund Exception excludes from the definition of "covered fund" any issuer that: is organized or established outside of the United States; is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction; and sells ownership interests predominantly through one or more public offerings outside of the United States.

For these purposes, the term "public offering" means a distribution (as defined in the Final Regulations) [3] of securities in any jurisdiction outside the United States to investors, including retail investors, provided that:

> (a) the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made;
>
> (b) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and
>
> (c) the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.

The Agencies noted that, for purposes of this exception, "retail investors" will be construed to refer to members of the general public who do not possess the level of sophistication and investment experience typically found among institutional investors or high net worth investors. They indicated that a foreign fund's distribution would not be a public offering for purposes of the Foreign Public Fund Exception if it is limited to investors having a minimum net worth or net investment assets. The Agencies further noted that they generally expect that an offering is made "predominantly outside the United States" if 85% or more of the fund's interests are sold to investors that are not residents of the Unites States.

The Final Regulations impose additional requirements in the case of a foreign public fund sponsored by a banking entity that is, or is controlled directly or indirectly by, a banking entity located in the United States or organized under U.S. law. In those circumstances, the sponsoring banking entity may not rely on the Foreign Public Fund Exception unless ownership interests in the fund are sold predominantly to persons other than: (i) the sponsoring banking entity, (ii) the issuer, (iii) affiliates of the sponsoring banking entity or the issuer, or (iv) directors and employees of such entities. [4] In addition, a U.S. banking entity with more than $10 billion in total consolidated assets will be required to document its investments in foreign public funds. [5]

To the extent that the Foreign Public Fund Exception might be unavailable for some non-U.S. retail funds, it is important to note that the Final Regulations substantially revised and narrowed the circumstances under which a foreign fund will be treated as a covered fund. [6] Under the Final Regulations, a foreign fund becomes a covered fund only with respect to a U.S.-based banking entity or a foreign affiliate of a U.S. banking entity that either acts as a sponsor to the foreign fund or has an ownership interest in the foreign fund. For these purposes, a U.S. branch, agency, or subsidiary of a foreign banking organization is deemed to be located in the U.S. A foreign bank that operates or controls such a branch, agency, or subsidiary is not considered to be located in the U.S. solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary. The preamble points out that, under this approach, the same foreign fund may be a covered fund with

respect to a U.S. banking entity that sponsors it, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside of the United States.

Treatment of Registered Funds under the Definition of "Banking Entity"

The release accompanying the Proposed Rule suggested that a mutual fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it (and hence the fund would not be treated as a banking entity subject to the Volcker Rule in its own right). ICI and ICI Global raised concerns that, without an express exclusion in the rule text, it could be possible for some registered funds—particularly during the seeding period, when all or nearly all of a fund's shares are owned by its sponsor—to become subject to all of the prohibitions and restrictions in the Volcker Rule.

The preamble discusses the treatment of registered investment companies in regard to their potential status as banking entities. The Agencies note that for purposes of the Volcker Rule, a financial holding company may own more than 5% and less that 25% of the voting shares of a registered investment company for which the financial holding company provides investment advisory, administrative and other services without controlling the registered investment company. The Agencies observe that so long as a holding company complies with these limitations, it would not, absent other facts and circumstances, control a registered investment company, and thus the fund would not be a banking entity subject to the restrictions of the Volcker Rule, unless the fund itself otherwise controls an insured depository institution.

Similarly, the Agencies stated that a seeding vehicle that will become a registered investment company would not itself be viewed as violating the requirements of the Volcker Rule during the seeding period as long as the banking entity that establishes the seeding vehicle operates the vehicle pursuant to a written plan developed in accordance with the banking entity's compliance program, which reflects the banking entity's determination that the vehicle will become a registered fund within the time period for seeding a customer fund under the Final Regulations. [7]

The preamble does not explicitly address the potential status of non-U.S. retail funds as banking entities.

Ability of Banking Entities to Serve as Authorized Participants for U.S. and Non-U.S. Registered Exchange-Traded Funds and/or Engage in ETF Market Making Activities

As drafted, the proprietary trading provisions of the Proposed Rule raised questions as to the ability of banking entities to serve as Authorized Participants ("APs") for exchange-traded funds ("ETFs") and/or conduct market making activities relating to ETFs. Among other things, ICI and ICI Global stressed the importance of AP activities in maintaining efficient pricing in the ETF marketplace and protecting ETF investors. We urged the Agencies to revise the Proposed Rule to ensure that banking entities can continue to fulfill these important roles.

The preamble to the Final Regulations includes substantial discussion of issues raised under the Volcker Rule regarding trading in ETF shares. That discussion confirms that the Agencies did not intend to place substantial restrictions on the ability of banking entities to serve as APs to ETFs and conduct various trading activities connected to that function. The Agencies state explicitly that the activities of banking entity APs regarding ETF shares can

qualify under the market-making exemption, including: (a) acquiring or accumulating an inventory of financial instruments for the purpose of conveying such instruments to the ETF in return for a "creation unit" of ETF shares; (b) engaging in ETF-loan (i.e., "create-to-lend") transactions; and (c) generally engaging in buying and selling shares of an ETF and its underlying instruments in the market to maintain price continuity between the ETF and its underlying instruments.

The Agencies also specified that banking entities that do not serve as APs could utilize the market-making exemption for the type of arbitrage trading meant to maintain price continuity between an ETF and its underlying instruments, "[b]ecause customers take positions in ETFs with an expectation that the price relationship will be maintained." The preamble also recognizes that APs and other market makers in ETF shares will typically hedge their exposures, although the preamble does not specifically address such hedging in the discussion of the hedging exemption.

Impact on the Financial Markets

Proprietary Trading Prohibition and Permitted Activity Exemptions

In our comments on the Proposed Rule, we stressed that banking entities are key participants in providing liquidity in the financial markets, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading. We expressed concern that the complexities of complying with the Proposed Rule and its various exemptions from the proprietary trading prohibition potentially could decrease liquidity, especially for the fixed-income and derivatives markets and the less liquid portions of the equities markets. In particular, our letter asserted that the proposed exemption for market making did not reflect that market makers provide liquidity by acting as principal in the majority of the financial markets, nor did it take into account the need for flexibility and discretion on the part of market makers to enter into transactions to build inventory.

The Final Regulations generally follow the same structure as the Proposed Rule, broadly defining "proprietary trading" to include the trading of "financial instruments" by a banking entity as "principal" for its "trading account." Among other things, the Final Regulations retain the rebuttable presumption that any financial instrument held for less than 60 days is presumed to be for a trading account. The specifics of the permitted activity exemptions have been modified to varying degrees, as described in the preamble. The market making exemption was substantially revised, so that its applicability is now determined based on the general market making activities of a banking entity's trading desk, rather than on a transaction by transaction basis. It requires, among other things, that the amount, types and risks of the financial instruments in the trading desk's "market maker inventory" must be designed not to exceed, on an ongoing basis, the "reasonably expected near term demands of clients, customers and counterparties." As the preamble explains, the revised market maker exemption is intended "to better account for the varying characteristics of market making-related activities across markets and asset classes, while requiring that banking entities maintain a robust set of risk controls for their market making-related activities." These risk controls are in addition to the compliance requirements generally applicable to banking entities under the Final Regulations.

Permitted Trading in Certain Government and Municipal Obligations

Under the Proposed Rule, the exemption for trading in certain government obligations did not extend to transactions in obligations of an agency or instrumentality of any State or

political subdivision. ICI's comment letter recommended that the exemption be expanded to include all municipal securities, consistent with the current definition of municipal securities under the Securities Exchange Act of 1934. We and other commenters also urged that the Proposed Rule be expanded to provide an exemption for foreign sovereign obligations, which would be consistent with Congressional intent to limit the extraterritorial reach of the Volcker Rule and with the purposes of the Volcker Rule.

With respect to municipal securities, the Final Regulations seek to address commenters' concerns by adopting a revised definition that is "modeled after" the definition of "municipal securities" under the Securities Exchange Act. [8] The Final Regulations also provide a limited exemption for trading in obligations of foreign sovereign debt. They generally permit the U.S. operations of foreign banking entities to engage in proprietary trading in the United States in the foreign sovereign debt of the foreign sovereign under whose laws the banking entity (or the banking entity that controls it) is organized and any multinational central bank of which the foreign sovereign is a member, so long as the purchase or sale as principal is not made by an insured depository institution. This permitted trading activity also extends to obligations of political subdivisions of the foreign banking entity's home country. The Final Regulations do not allow a banking entity to engage in proprietary trading in derivatives on foreign sovereign debt.

In the preamble, the Agencies explain that the Final Regulations allow the U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign debt in the same manner as U.S. banking entities are permitted to support the smooth functioning of U.S markets in government and agency obligations. The Agencies also note that the Final Regulations implement the statutory market making and underwriting exemptions and therefore the key role of banking entities in facilitating trading and liquidity in foreign government debt through market making and underwriting was maintained. In addition, the Agencies commented that the Final Regulations do not prevent foreign banking entities from trading foreign sovereign debt (including sovereign debt of countries other than that of their home country) outside the United States.

Investment Opportunities for Registered Funds

Investments in Certain Foreign Securities

As contemplated by Section 619, the Proposed Rule provided an exemption from the proprietary trading prohibition for trading outside of the United States ("foreign trading exemption"). As proposed, however, the exemption narrowly defined which transactions would be considered to take place outside of the United States—and, in so doing, it departed from Regulation S under the Securities Act of 1933. [9] ICI and ICI Global expressed concerns about disruptions in the global securities markets, including trading with market participants identified as residents of the United States. We cautioned that this narrow exemption could cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered investment companies or even non-U.S. retail funds advised from the United States, even when those transactions would comport fully with Regulation S. [10] As a result, access to non-U.S. counterparties could decrease significantly, and liquidity in some markets could be reduced. We recommended revising the Proposed Rule to conform to the existing approach under Regulation S.

The Final Regulations did not take this approach. The Agencies did, however, modify the requirements for the foreign trading exemption in a number of respects. Among other

requirements, the exemption is generally available to qualifying foreign banking entities only if: (i) the banking entity engaging as principal in the purchase or sale (including any personnel that arrange, negotiate or execute the purchase or sale) is not located in the United States or organized under U.S. law; (ii) the banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under U.S. law; (iii) the purchase or sale, including any related hedging, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate located in the United States or organized under U.S. law; (iv) no financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate located in the United States or organized under U.S. law; and (v) the purchase or sale is not conducted with or through any U.S. entity (which is defined as any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity located in the U.S. or organized under U.S. law).

With respect to a U.S. entity, the following transactions are permitted: (a) a purchase or sale with the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale; (b) a purchase or sale with an unaffiliated market intermediary acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or (c) a purchase or sale through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

The preamble states that the Agencies believe that the ability of non-U.S. banking entities to deal with the foreign operations of a U.S. entity (and other modifications) should address commenters' concerns that the Proposed Rule could cause foreign banking entities to avoid conducting business with U.S. firms outside the United States or could incentivize foreign markets to restrict access to U.S. firms.

Asset-Backed Commercial Paper and Tender Option Bond Programs

ICI's comment letter raised concerns that the Proposed Rule would impair two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper ("ABCP") programs and securities issued pursuant to municipal tender option bond ("TOB") programs. We indicated that this would have significant negative implications for issuers of these financing vehicles and their investors, many of which are registered funds, and recommended that the Proposed Rule be revised to exempt ABCP and TOB programs.

ABCP Conduits. The Final Regulations contain an exclusion from the definition of "covered fund" for ABCP conduits. To qualify for the exclusion, issuers of asset-backed commercial paper may only hold assets permissible for loan securitizations [11] and asset-backed securities supported solely by assets permissible for loan securitizations and acquired directly from the related issuer or underwriter as part of the initial issuance. The conduit may only issue residual interests and securities maturing in 397 days or less, and must have a "regulated liquidity provider" committed to providing full and unconditional liquidity coverage. [12]

TOB Programs. The preamble discusses comments the Agencies received addressing how the Final Regulations should treat TOB programs. It indicates that after carefully

considering these comments, the Final Regulations do not provide a specific exclusion for TOB programs. It explains the Agencies' analysis that led to this result. The preamble acknowledges that:

> The extent to which the final rule causes a disruption to the securitization of, and market for, municipal tender option bonds may also affect the economic burden and effects on the municipal bond market and its participants, including money market mutual funds and issuers of municipal securities. The Agencies recognize that a potential economic burden may be an increase in financing costs to municipalities as a result of a decrease in demand for the types of municipal securities typically included in municipal tender option bond vehicles and therefore potential effects on the depth and liquidity of the market for certain types of municipal securities. [13]

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endnotes

[1] See, e.g., Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, SEC Release No. BHCA-1, File No. S7-41-11 (Dec. 10, 2013), available at http://www.sec.gov/rules/final/2013/bhca-1.pdf. In a related action, the Federal Reserve Board extended the conformance period for compliance with the Volcker Rule and Final Regulations by one year, to July 21, 2015.

[2] The Final Regulations similarly exclude business development companies from the definition of covered fund.

[3] In the Final Regulations, a distribution of securities means: (i) an offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act of 1933. For non-U.S. retail funds, only the first prong of the definition will apply because the shares of those funds are not registered under the Securities Act of 1933.

[4] The Agencies likewise noted that they would generally expect that a fund would satisfy these additional ownership requirements if 85% or more of the fund's interests are sold to persons other than the sponsoring U.S. banking entity and certain persons connected to that entity.

[5] If the U.S. banking entity and its affiliates' ownership of foreign public funds exceeds

$50 million at the end of two or more consecutive calendar quarters, the U.S. banking entity will be required to document such ownership, broken out by each foreign public fund and each foreign jurisdiction in which any foreign public fund is organized.

[6] More specifically, the definition of "covered fund" includes an entity that: (i) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and (iii) has as its sponsor a U.S. banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by a U.S. banking entity (or an affiliate thereof).

[7] Such a seeding vehicle also must comply with the requirements of Section 18 of the Investment Company Act of 1940.

[8] The Final Regulations define the term "municipal security" to mean "a security which is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality."

[9] Regulation S governs whether an offering takes place outside of the United States.

[10] We explained that many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States, and that these transactions often involve non-U.S. banking entities as counterparties.

[11] The Final Regulations exclude "loan securitizations" by carving out from the definition of "covered fund" any "issuing entity for asset-backed securities," provided that the issuing entity holds only: (i) "loans" (including "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative"); (ii) rights and other assets related to owning and servicing the loans and distributing the proceeds of the loans to investors; (iii) certain interest rate and currency derivatives that actually reduce interest rate and/or foreign exchange risk relating to the loans and other assets held by the issuer; and (iv) certain special units of beneficial interest and collateral certificates. To fall within this exclusion, an issuer can hold cash equivalents and securities received in lieu of debts (typically in connection with the settlement of a distressed loan), but cannot hold other securities (including asset-backed securities), other derivatives (including credit derivatives), or commodity forward contracts.

[12] For these purposes, a "regulated liquidity provider" includes a depository institution within the meaning of the Federal Deposit Insurance Act, a bank holding company (or a subsidiary thereof) within the meaning of the Bank Holding Company Act, a savings and loan holding company (or a subsidiary thereof) within the meaning of the Home Owners' Loan Act whose activities are permissible under section 4(k) of the Bank Holding Company Act, a foreign bank whose home country supervisor has adopted Basel-consistent capital standards, or the United States or any foreign sovereign.

[13] Preamble at 597 (footnotes omitted).